

Appeal from a decision of the Director, Minerals Management Service, affirming the assessment of additional royalties for gas production and late payment charges. MMS-84-0019-O&G.

Reversed in part; set aside in part, and remanded.

1. Oil and Gas Leases: Royalties

The regulation at 30 CFR 206.105(c) (1986) provides that for the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater. In accordance with that regulation and the other regulations governing gas valuation for royalty purposes, as well as longstanding Departmental practice, wet gas which is not sold at the wellhead because it is unmarketable in that condition, but is processed by an independent third party pursuant to an arm's-length contract, is properly valued for royalty purposes during the period December 1975 through May 31, 1977, in accordance with the terms of that contract, on the value of 100 percent of the dry residue gas at the tailgate of the processing plant and 35 percent of the extracted liquids.

2. Oil and Gas Leases: Royalties

Where the Director, Minerals Management Service, concludes that the proper royalty on gas production from June 1, 1977, through Aug. 31, 1981, is, in accordance with the regulations in 30 CFR Part 206 and Notice to Lessees and Operators No. 1, the greater of the value of the unprocessed gas at the wellhead adjusted for its Btu content or the value of the processed gas and extracted liquids, less allowable processing costs, at the tailgate of the processing plant, yet during that time period Notice to Lessees and Operators No. 5, a

duly promulgated regulation of the Department of the Interior, also controlled valuation, the Director's decision may be set aside and the case remanded for consideration of valuation in light of all applicable regulations.

APPEARANCES: Ryland J. Gill, Jr., Esq., Robert H. Lovell, Esq., Wexpro Company, Salt Lake City, Utah, and John F. Shepherd, Esq., Denver, Colorado, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HARRIS

Wexpro Company (Wexpro), a division of the Mountain Fuel Supply Company (Mountain Fuel), has appealed from a decision of the Director, Minerals Management Service (MMS), dated September 30, 1986, affirming the assessment of additional royalties in the amount of \$227,351 and late payment charges in the amount of \$110,812.90 with respect to gas produced from Federal oil and gas leases in the Spearhead Ranch Unit in Converse County, Wyoming. ^{1/}

This case stems from an October 1982 "Audit Report" prepared by the U.S. Department of the Interior, Office of Inspector General (OIG). Therein, OIG concluded that Mountain Fuel had underpaid royalties on gas produced from Federal oil and gas leases in the Spearhead Ranch Unit between December 1975 and August 1981.

The following facts are undisputed. On July 7, 1975, Mountain Fuel entered into an arm's-length gas processing contract with American Quasar Petroleum Company (American Quasar), which agreed to construct a gas processing plant to process wet gas from the Spearhead Ranch area. The gas produced from the leases in question was a very wet gas, which although initially sold at the wellhead, was subsequently determined not to be marketable in the wet condition, and during the time periods relevant to this case was not sold at the wellhead, but was processed by American Quasar pursuant to the contract. Other producers in that area also entered into gas processing contracts. In December 1975 the plant began processing gas. Following the processing of its wet gas, Mountain Fuel received 100 percent of the dry residue gas. American Quasar charged Mountain Fuel a fee to process its wet gas. That fee was 65 percent of the liquid hydrocarbons extracted. American Quasar sold the remaining 35 percent share of liquids owned by Mountain Fuel and credited the proceeds to Mountain Fuel's account. Thus, Mountain Fuel paid royalties on 100 percent of its dry residue gas and on its share (35 percent) of the liquid hydrocarbons extracted.

^{1/} In its Supplemental Statement of Reasons (SOR) at pages 1-3, Wexpro explained the relationship between Wexpro and Mountain Fuel during the relevant period. Mountain Fuel produced gas from the Spearhead Ranch Unit from December 1975 through December 1976. Thereafter, Wexpro produced gas for Mountain Fuel on a cost of service basis. References in the decision to Wexpro or Mountain Fuel will include the other company where appropriate.

OIG found, however, that a proper determination of the "reasonable value," under 30 CFR 221.47 (1982) (see note 4, *infra*), of gas produced from the leases required a comparison of the aggregate value of the residue gas and allocated liquid products with the value of the gas at the wellhead in accordance with 30 CFR 221.50(c) (1982), 2/ and, based on that comparison, the highest values derived from use of the latter method. It concluded that Mountain Fuel had underpaid royalties in the amount of \$227,351 for the period December 1975 to August 1981. 3/ It recommended the assessment of additional royalties in that amount.

By letter dated November 9, 1983, the Regional Manager, Lakewood Regional Compliance Office, MMS, assessed Wexpro additional royalties in the amount of \$227,351. The Regional Manager also directed Wexpro to review royalty calculations for periods after August 1981 and, "if necessary, recalculate and pay royalties in accordance with the criteria defined in the [Audit Report]." Finally, the Regional Manager stated that "[l]ate payment penalties will be assessed at a later date consistent with applicable regulatory criteria." On December 13, 1983, Wexpro appealed to the Director, MMS, from the assessment of additional royalties. On January 9, 1984, Wexpro paid those additional royalties under protest. At the same time, it also paid under protest additional royalties for the period August 1981 to November 1983 (\$43,732.96), which it calculated would be due according to the audit criteria.

By letter dated July 16, 1984, the Regional Manager, Lakewood Regional Compliance Office, assessed Wexpro late payment charges in the amount of \$110,812.90 for the period between December 1975 and November 1983. On July 30, 1984, Wexpro paid the late payment charges under protest. The payment was deemed to be an appeal from the assessment of the late payment charges, and the appeal was consolidated by MMS with Wexpro's appeal from the assessment of additional royalties.

In his September 1986 decision, the Director, MMS, affirmed the assessment of additional royalties and late payment charges. He found that Wexpro's method of valuation which looked only at the gross proceeds received by the lessee, i.e., the gross proceeds of the sale of the dry

2/ That regulation, which is the same as 30 CFR 206.105(c) (1986), provided: "For the purpose of computing royalty the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater."

3/ The report noted that Mountain Fuel had not sold the wet gas, and therefore, had derived no "gross proceeds" from such a sale, within the meaning of 30 CFR 221.50(c) (1982), but concluded that the "expressed intent of the regulations that royalty be based on the 'greater' or 'highest' value cannot be defeated simply by [Mountain Fuel's] failure to make a sale of wet gas" (Audit Report at 7).

residue gas and the liquid products less the percentage of liquid products allocated to American Quasar as a processing cost, should be compared with the value of the unprocessed gas at the wellhead, adjusted for its Btu content, and royalty paid on the greater of those two values. In essence, the Director held that Wexpro should have been engaging in dual accounting.

The Director found it unpersuasive that Wexpro did not, in fact, sell its production as wet gas and that that fact did not deprive the Secretary of the discretion to consider its value in that form in determining, in accordance with 30 CFR 206.103 (1986), 4/ the reasonable value of the gas for royalty purposes. He concluded that royalty should have been paid based on the value at the wellhead of the wet gas adjusted for its Btu content. He also upheld assessment of late payment charges. On appeal Wexpro challenges both the assessment of additional royalties and the imposition of late payment charges. We will first examine the additional royalty challenge.

On appeal appellant principally contends that MMS is constrained to value gas produced from its leases in accordance with a longstanding Departmental practice which was incorporated by reference into those leases at the time of their issuance in the 1960's. Appellant states that this Departmental practice provides for the valuation of wet gas based on the greater of the lessee's gross proceeds from the sale of that gas, if the wet gas is sold as a single commodity, or the aggregate value of the residue gas and one-third (or more than one-third if the lessee's share is greater than one-third) of the liquid products, if the wet gas is processed and its constituent components sold as separate commodities. Based on this practice, appellant concludes that where wet gas is not sold but, instead, processed and its constituent components sold, the proper valuation is to use the aggregate value of the residue gas and the lessee's (one-third or more) share of the liquid products. Appellant argues that this approach properly incorporates an allowance for the cost of processing the wet gas. By contrast, appellant contends that MMS' method of valuing wet gas at

4/ 30 CFR 206.103 (1986), formerly 30 CFR 221.47, provides:

"The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value."

the wellhead, adjusted for Btu content, is contrary to the longstanding Departmental practice, does not take into account the cost of processing the wet gas, and was used in this case even though there was no market for the unprocessed wet gas.

In its answer MMS contends that it is justified in valuing gas at the wellhead since it has broad discretion under applicable statutes and Departmental regulations and there is a longstanding Departmental practice of valuing gas at the wellhead "if that is the higher value" (Answer at 5). MMS explains that this practice has been adopted "to ensure that the lessee does not diminish the value of the gas, and thus the royalty interest, by processing wet gas." Id. at 7.

The basic question presented by this case is whether MMS properly values wet gas produced from onshore Federal oil and gas leases by the value of the gas at the wellhead, adjusted for its Btu content, where the gas is not sold in its unprocessed state but, instead, is processed by an independent third party and its constituent components (dry residue gas and liquid products) then sold.

Section 17 of the Mineral Leasing Act, as amended, 30 U.S.C. § 226 (1982), provides for the assessment of royalty "in amount or value of production removed or sold from the lease." The statute does not set forth any particular method for valuing production removed or sold from a Federal oil and gas lease. However, it is well established that the Secretary of the Interior has "considerable latitude" in determining the value of oil and gas production as a basis for computing royalties. Hoover & Bracken Energies, Inc., 52 IBLA 27, 33 (1981), rev'd, Hoover & Bracken Energies, Inc. v. United States Department of the Interior, No. 81-461-T (W.D. Okla. Nov. 18, 1981), rev'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984).

Since the enactment of the Mineral Leasing Act in 1920, however, the valuation of oil and gas production for royalty purposes has been circumscribed by Departmental regulations. In the earliest promulgation of applicable regulations, the Secretary provided that the value of "casing-head gas" (wet gas) would be either one-third of the value of marketable casing-head gasoline ^{5/} extracted from the gas or the price received by the lessee for the casing-head gas if higher than the equivalent of the one-third value. 47 L.D. 552, 555 (1920).

The Secretary revised those regulations in 1926. 52 L.D. 1 (1926). In section 4(c) of the revision regulations, the Secretary indicated that royalty would be due on 100 percent of the "dry gas" produced, whether produced as dry gas from the well or as residual dry gas from a plant after natural-gas gasoline had been extracted. Id. at 10-11. He also provided

^{5/} Casing-head gasoline is defined as the "liquid hydrocarbon recovered from casing-head gas * * *. Also known as natural gasoline." Dictionary of Mining, Mineral, and Related Terms 180 (1968).

in section 4(d) that royalty would also be due on one-third of the value of the marketable natural-gas gasoline extracted, the "remaining two-thirds being allowed to the lessee for the cost of manufacture." 6/

The Secretary further provided:

In general, where natural gas is delivered or sold for purposes of extracting gasoline, two separate commodities are involved -- the natural-gas gasoline and the dry residue gas. If, however, the lessee receives a higher price for such natural gas as a single commodity than the combined value of the two commodities, the natural-gas gasoline and the dry residual gas, as fixed by the Secretary of the Interior, the Government royalty shall be computed on natural gas alone and at the higher price received therefor by the lessee.

Id. at 11. Thus, the Secretary determined by regulation that royalty would be required on the greater of the price received for the wet gas as a single commodity, if sold on that basis, or the combined value of the dry residual gas and one-third the value of the natural-gas gasoline extracted.

In 1936, the Secretary published the oil and gas regulations in the Federal Register. 1 FR 1996 (Nov. 20, 1936). Regarding royalty on gas and casing-head gasoline, the regulations provided that royalty on dry gas would accrue whether produced as such or as residue gas after the extraction of gasoline. The value of wet gas for the purpose of royalty, according to section 3(g) of those regulations, was to be "either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary * * * of all commodities, including residue gas obtained therefrom, whichever is greater." 1 FR at 2001. For casing-head or natural gasoline, the regulations stated at section 3(h) that royalty "shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required." Id.

Subsequently, in Instructions dated June 7, 1937, the Acting Secretary provided an interpretation of the 1926 regulations regarding the calculation of royalty on gas and derivative products. 56 I.D. 462 (1937). The

6/ The regulations explained:

"Natural-gas gasoline (also known as casing-head gasoline) is a manufactured product. The value of this product is contingent upon the value of the raw material and the cost of its manufacture. The Government does not wish to collect royalty on that part of the value which is derived from the cost of manufacturing, inasmuch as the Government's equity is confined to the value of the raw material involved. In computing royalty on natural-gas gasoline the value of the raw gasoline in the natural gas as produced is assumed to be one-third the value of the marketable natural-gas gasoline extracted from such gas, the remaining two-thirds being allowed to the lessee for the cost of manufacture."

Id. at 11.

instructions stated that the interpretation was necessary because improved processing equipment and methods, as well as conditions on some leases, resulted in the two-thirds manufacturing allowance being excessive in some cases. The Acting Secretary stated that "a lessee's natural gas production can not be valued for royalty purposes at less than the net amount which the lessee actually realizes from his current disposals of such natural gas in the field." 56 I.D. at 464. He instructed the Director of the Geological Survey (GS), in computing royalties, to charge lessees "either on the basis of the combined value" of the natural gas and derivative products "as measured by the lessee's gross field realizations less his actual extraction costs (net field realization value), or on the basis of the section 4(d) formula [the two-thirds manufacturing allowance], whichever may result in the higher valuation." 56 I.D. at 465. ^{7/}

The Secretary republished the 1936 oil and gas regulations, effective June 1, 1942, with only minor changes, and they were codified in the Code of Federal Regulations at Title 30. 7 FR 4132 (June 2, 1942). Those regulations remained in effect, virtually unchanged, except for CFR section numbers, until 1988 (see discussion *infra*). Thus, from early on the Departmental regulations in 30 CFR provided for collection of royalty on wet gas based on the greater of the lessee's proceeds from the sale of wet gas, if it was sold that way, or the combined value of the dry residue gas after processing and one-third of the liquids extracted (or more than one-third, if the lessee's share was greater than one-third).

Despite the consistency in the regulatory language, the Department, through the Conservation Division, GS, and later MMS, indulged in various valuation methods. Thus, on January 29, 1947, the Director, GS, issued a decision in memorandum form to the Secretary, describing the inequities of applying a literal interpretation of the regulations in the situation where the processors retained a portion of the dry gas residue as a manufacturing allowance. Under the contracts at issue in those cases, the lessee received 75 percent of the dry residue gas and 50 percent of the extracted liquids. Twenty-five percent of the gas and 50 percent of the liquids were retained by the processor. The Director explained:

The 1926 regulations [52 L.D. 1 (1926)] as interpreted [sic] by the instructions of June 7, 1937 [56 L.D. 462 (1937)], applied to the case here under consideration, would provide for a royalty computed on 75 per cent of dry residue gas and 50 per cent of liquids allocated to the producer at the prices actually received, with a minimum based on one-third of the gasoline and 100 per cent of the salable residue dry gas at the prices actually received, but at not less than any minimum prices established by the Secretary. A literal interpretation of the 1936 regulations and the

^{7/} These instructions were based on the 1926 regulations. There is no mention in the instructions of the 1936 regulations, and therefore, no acknowledgment that the 1936 regulations had modified the 1926 regulations by increasing the portion of the natural-gas gasoline production upon which royalty would be due from the value of one-third thereof to the value of one-third or the lessee's portion, if greater than one-third.

succeeding regulations of June 1, 1942, 30 C.F.R. 221, under the same circumstances require computation of royalty on the basis of 100 per cent of the salable residue dry gas and, because of the inclusion of the parenthetical phrase "or the lessee's portion if greater than one-third" in section 221.42 of the 1936 regulations and section 221.52 of the 1942 regulations, on the basis of 50 percent of the liquids.

As previously explained, the above-mentioned sections of the 1936 and 1942 regulations are based on the faulty premise that the cost of manufacture will always be reflected in the retention by the processor of a portion of the extracted liquids only and in the cases here under consideration where the cost of manufacturing is expressed in the retention by the processor of both gas and liquids, it is apparent that certain inequities in royalty computation have resulted. Application of the principles expressed in the Acting Secretary's instructions of June 7, 1937, to the 1936 and 1942 regulations would eliminate any such inequities in the computation of Federal royalty on natural gas and its derivative products.

(Decision at 3). He recommended

that in computing royalties due the United States on natural gas, including its derivative products, produced from any Federal oil and gas lease that such royalty be computed on one of the following bases, whichever results in the greater royalty, whenever it appears to the satisfaction of the Geological Survey that the cost of manufacture is effected in both gas and liquids retained by the processor.

1. The basis of the gross market value of all such products less extraction cost; or on

2. The basis of one-third of the gasoline, butane, propane, and other liquid substances extracted from the gas and all of the residue dry gas available for sale at not less than the established minimum prices. If no minimum prices have been established, the market value obtainable by the lessee shall be used.

(Decision at 4). Acting Secretary Chapman approved that decision on February 28, 1947.

GS thereafter apparently adopted that valuation method. The 1974 Conservation Division Manual (CDM), GS, states:

As stated in 30 CFR 221.50 [30 CFR 206.105 (1986)] and 221.51 [30 CFR 206.106 (1986)], royalty shall be based on the value of one-third (or the lessee's portion if greater than one-third) of all liquids extracted from the gas plus 100 percent of the residue gas. This regulation assumes that the cost of manufacturing is reflected by the plant operator retaining only liquids. However, existing regulations do not take into consideration those

instances where a portion of the manufacturing allowance for processing liquids is reflected in the residue gas retained by the plant operator. Royalty settlement in such instances may be based on the larger value derived from either (1) gross proceeds to the lessee, (2) 100 percent of the residue gas plus a flat one-third of the liquids, (3) a gross value of all products less plant extraction costs.

CDM 647.3.3C (1974).

In 1977, GS abandoned this earlier policy of gas valuation in favor of a new policy, again without any change in the regulations in 30 Code of Federal Regulations. In CDM Release No. 35, dated August 15, 1977, the Director, GS, stated that the Manual was being revised "to implement the requirements of NTL [Notice to Lessees and Operators]-5." NTL-5, which had an effective date of June 1, 1977, stated:

In recognition of the increasing value of natural gas, greater acceptance of the Btu method for gas settlement, and the need to assure the receipt of the fair market value for gas produced from leases under its jurisdiction, the Geological Survey concluded it was necessary to modify its procedures for determining the value of natural gas for royalty computation purposes.

42 FR 22610 (May 4, 1977).

The CDM summed up the changes as follows:

[T]he general policy of the Geological Survey is that, effective June 1, 1977, royalty values will be based on the higher of:

- (1) The volume, Btu content and value of the gas at the lease in accordance with the guidelines contained in this chapter; or
- (2) The gross proceeds accruing to the lessee from the sale or other disposition of the gas; or
- (3) 18 cents per Mcf at 60 degrees F. and 14.73 psia, subject to Btu and other appropriate adjustments described in this chapter.

Where production prior to June 1, 1977, had been improperly valued for royalty purposes, any retroactive adjustment of such royalty values shall be made based on the guidelines which were effective for such period, e.g., net realization, highest price paid for a majority of production, etc., as appropriate. In other words, based on the principle that corrected interpretations are to be applied prospectively from the date of Notice, the guidelines contained in NTL-5 are not applicable to production prior to June 1, 1977.

CDM 647.2.3A (1977).

Thereafter, MMS, effective August 1, 1986, modified NTL-5 to provide simply that royalty value would be determined "pursuant to 30 CFR Part 206." 51 FR 26759, 26765 (July 25, 1986). It explained that "NTL-5 as amended * * * refers to all of 30 CFR Part 206, not just 206.103. Thus, wet gas will be valued in accordance with the provisions of 206.105 and 206.106 and other provisions in Part 206, as applicable." 51 FR at 26761. MMS stated in the notice that the modification would be applied prospectively (51 FR at 26761). However, on January 6, 1988, Congress found it necessary, due to inequitable situations, to provide, through legislation, for certain retroactive adjustments in the valuation of gas for royalty purposes. It therefore enacted the Notice to Lessees Numbered 5 Gas Royalty Act (NTL-5 Act). P.L. 100-234, 101 Stat. 1719 (1988). ^{8/} Section 3(a) of that Act stated that the value for royalty purposes of any gas production from Federal onshore or Indian leases during the period January 1, 1982, through July 31, 1986, which was subject to NTL-5, would be computed in accordance with section 3(b) of the Act. That section provides:

(b) ROYALTY CALCULATION FOR CERTAIN FEDERAL ONSHORE AND INDIAN OIL AND GAS LEASES. -- If the gas referred to in subsection (a) of this section was produced from a Federal onshore or Indian lease, the value of production for the purpose of computing royalty, shall be the reasonable value of the product as determined consistent with the lease terms and the regulations codified at part 206 of title 30, Code of Federal Regulations in effect at the time of production. In establishing the reasonable value, due consideration shall be given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per thousand cubic feet or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality gas, or other products produced and sold from the field or areas where the leased lands are situated will be considered to be a reasonable value. [^{9/}]

101 Stat. at 1720.

The first sentence of that section states that gas valuation shall be the reasonable value of the product, as determined by the regulations in 30 CFR Part 206. The next two sentences are essentially a quote of 30 CFR 206.103.

^{8/} Congress specifically found in section 1(b) of the Act that NTL-5 and the 1986 modification thereof were duly promulgated regulations of the Department. 101 Stat. at 1719.

^{9/} In the Department's 1988 revision of the gas valuation regulations (see discussion, infra), NTL-5 was terminated. 53 FR 1272 (Jan. 15, 1988).

It is appellant's position that MMS' action in this case is contrary to the Department's longstanding interpretation of the regulations in 30 CFR Part 206. We agree to the following extent.

[1, 2] The MMS Director's decision relies on the regulation at 30 CFR 206.103 (1986) for "authority to calculate royalty based on the value at the wellhead of the wet gas adjusted for its Btu content," even when the gas is not sold as such but rather processed and its constituent components sold (Decision at 7). That regulation provides for the establishment of the estimated reasonable value of the product, taking into consideration other relevant matters. That regulation, however, is the general regulation relating to valuation for royalty purposes. The specific regulations regarding the valuation of wet gas are found at 30 CFR 206.105 (1986) and 30 CFR 206.106 (1986). 30 CFR 206.105(c) (1986) states: "For the purposes of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater." (Emphasis added.)

30 CFR 206.106 addresses the valuation of the liquid hydrocarbons extracted from the wet gas. It provides that royalty shall be computed on the value of one-third (or the lessee's portion if greater than one-third) of those products.

MMS states that at page 22 of its Supplemental SOR appellant argues that the specific regulations relating to wet gas valuation should take precedence over the general regulation at 30 CFR 206.103 (1986). MMS disagrees, asserting that the regulations in Part 206 of 30 CFR should, like statutes, be looked at as a whole and applied as a whole. MMS mischaracterizes appellant's argument. Appellant asserts that the Secretary's general authority to set reasonable values is applicable to the specific wet gas regulations in the sense that reasonable values may be established for the formula used in the specific regulations for dry residue gas and the extracted liquids. Appellant explains:

In other words, the specific provisions in §§ 206.105 and 106 set forth the methodology for calculating the royalty on wet gas as 100% of the dry gas and 33 1/3% (or more, if the lessee's share is greater) of the liquids extracted. Section 206.103 allows the Secretary to determine the value of the dry gas and the value of the liquids by looking to the factors set forth therein (highest price paid for a part or for a majority of production of like quality in the same field, the price received by the lessee, posted prices and other relevant matters).

(Supplemental SOR at 22). Appellant continues by stating that "[e]ven if there were some ambiguity in the regulations," well-established rules of construction dictate that the specific regulations should control over the general (Supplemental SOR at 23).

It is clear that in construing regulations the principles of statutory construction are applicable, Rucker v. Wabash Railroad Co., 418 F.2d 146, 149 (7th Cir. 1969); see generally 1A C. Sands, Statutes and Statutory Construction § 31.06 (4th ed. 1985), and that in cases of an inescapable

conflict between specific and general provisions of a statute, the specific provisions will prevail. American Postal Workers Union, AFL-CIO v. United States Postal Service, 707 F.2d 548, 555 (D.C. Cir. 1983), cert. denied, 465 U.S. 1100 (1984); 2A C. Sands, Statutes and Statutory Construction § 46.05 at 92 (4th ed. 1985). However, not even appellant asserts that there is a conflict, and we find none. The question is whether the regulations, read as a whole, support MMS' position or that espoused by appellant.

The Director of MMS further justified his decision in this case by stating that "[w]here, as here, questions arise regarding the lessee's postprocessing valuation, it is reasonable for the lessor to consider the value of the wet gas based on its Btu content" (Decision at 7). MMS does not identify precisely what those "questions" are, although they apparently relate to the lack of an arm's-length contract between Wexpro and Mountain Fuel. In its Supplemental SOR at pages 23-24, appellant explained its valuation process:

[W]hile Wexpro does not have an arms-length contract to sell the dry gas to Mountain Fuel, Wexpro valued the dry gas at the price paid by Mountain Fuel to other working owners who had arms-length contracts. During the audit period, that price was the ceiling price established by the FPC [Federal Power Commission] or NGPA [Natural Gas Policy Act]. Stokes Affidavit PP9, 12 (Exhibit 1). Therefore, even if Wexpro had an arms-length contract with somebody, it would not (and could not) have valued the dry gas at any higher price.

With respect to the liquids extracted, Wexpro valued its share of the liquids based on the price American Quasar obtained for it pursuant to arms-length contracts, which happened to be the price all other working interest owners obtained. Similarly, the processing charge paid to American Quasar (65% of the liquids) was arrived at in an arms-length contract, and there is no evidence that this charge was excessive. See Stokes Affidavit ¶ 13. Indeed, Quasar charged all working interest owners the same processing fee, and this fee is within the Secretary's historic manufacturing allowance.

MMS has not disputed appellant's recitation of its valuation process. MMS' concern about "questions" over appellant's postprocessing valuation are not well founded and do not support its use of the Btu method of valuation, as discussed below.

MMS also finds support for its position to value Wexpro's wet gas at the wellhead, even though it was not sold as such, by resort to NTL-1. NTL-1, issued by the Acting Director, GS, and published in the Federal Register on January 25, 1977 (42 FR 4546), provided that royalty value may be adjusted "to reflect the Btu content of the gas regardless of whether the gas is sold on that basis." Id. at 4648. It also stated that the operator could be required to submit information showing the "value of gas at the wellhead adjusted for its Btu content." Id.

MMS asserts that NTL-1 reflects the long-established principle that the Secretary has broad discretion in selecting the proper valuation method. We do not disagree with that statement; however, that discretion must be exercised within the parameters of the Secretary's regulations. Appellant responds that the Btu method first arose in NTL-1 and subsequently was endorsed in NTL-5. Appellant asserts it is not entirely clear from the NTL's, and the portion of the 1977 CDM Manual quoted supra, whether the Director, GS, intended for the Btu method of valuation to be used where wet gas is processed under an arm's-length contract and sold or transferred at the tailgate of the processing plant. Appellant complains that the effect of applying the Btu method to its situation is to require dual accounting. It asserts that the decision in Jicarilla Apache Tribe v. Supron Energy Corp., 728 F.2d 1555 (10th Cir. 1984), supports its position that dual accounting is not a longstanding practice of the Department under circumstances such as those that exist in this case. In that case, involving the valuation of gas extracted from wells on the Jicarilla Reservation, royalty was paid on the basis of the price received for wet gas sold at the wellhead based on Btu content. The Tribe sued seeking to force the Secretary to require the lessees to value the dry gas and extracted liquids (less a manufacturing allowance) and pay royalty thereon, if it were greater than the wellhead valuation. The case was, in effect, the reverse of the present situation.

The court found that the Department had historically "construed the lease provisions and the regulations to require dual accounting not by all lessees, but only in instances where the lessee owned the processing plant * * *." (Emphasis in original.) Id. at 1558. Although the court's decision was affirmed in part and reversed in part upon rehearing en banc (782 F.2d 855 (10th Cir.), cert. denied, 107 S. Ct. 471 (1986)), partially on the basis that the Secretary's fiduciary responsibility dictated dual accounting for Indian leases, the court's original finding regarding the Department's practice concerning dual accounting remains viable. In this case no fiduciary responsibility exists, and it appears the Department's longstanding practice, acknowledged in Supron, of not requiring dual accounting, except where the lessee owns the processing plant, would generally not support a conclusion that dual accounting should apply where there is an arm's-length contract to process wet gas.

Appellant makes a good case that, under the regulations in 30 CFR Part 206, MMS erred in applying the Btu method of valuation, and we would reverse the Director's decision in toto were it not for NTL-5 and the NTL-5 Act. It appears that different methods of valuation may be applicable to the time period involved in this case. MMS required additional royalty for the period December 1975 through August 1981, and appellant paid under protest additional royalties calculated on the Btu method for September 1981 through October 31, 1983.

As set forth supra, the CDM specifically stated that guidelines included in NTL-5, inter alia, the Btu method of valuation, were "not applicable to production prior to June 1, 1977," the effective date of NTL-5. CDM 647.2.3A (1977). Thus, the Btu method of valuation clearly was not applicable to appellant's gas production from December 1975 through

May 31, 1977. 10/ The Director's decision must be reversed to that extent. We conclude that appellant paid the proper royalties for that period in accordance with the regulations in 30 CFR Part 206.

For the period June 1, 1977, through December 31, 1981, it appears that the standards set forth in NTL-5, as issued in 1977, should also be considered in determining valuation. 11/ For the period from January 1, 1982, through October 31, 1983, the NTL-5 Act dictates the proper procedures.

Under the circumstances, we find the proper action is to set aside the Director's decision to the extent it applied the Btu method for the period June 1, 1977, through August 31, 1981, and remand it to the Director to reconsider the gas valuation for that period in light of our discussion in this case. On remand he should also consider the proper valuation for the period September 1, 1981, through October 31, 1983, for which appellant voluntarily paid, under protest, additional royalties based on the Btu method of valuation.

We also set aside that part of the Director's decision assessing late payment charges until the Director makes a determination as to the amount of any additional royalties that may be due.

In addition, we note that during the pendency of this appeal, the Department completely revised the rules applicable to the valuation of oil and gas for royalty computation purposes. Effective March 1, 1988, the Department removed or revised 30 CFR 206.103, 206.105, and 206.106 (1986) (53 FR 1218, 1222, and 1226 (Jan. 15, 1988)) and terminated NTL-1 and NTL-5 (53 FR at 1272). In place of those rules and directives, the Department instituted a new system of regulations for valuing gas to apply prospectively to gas produced on or after March 1, 1988, the effective date of the final rulemaking. 53 FR at 1230.

10/ Clearly, the Secretary has substantial latitude in valuing gas for royalty purposes. MMS argues that such latitude is necessary because "circumstances vary greatly among the 20,000 operating federal and Indian oil and gas leases" and for that reason the Secretary must be able to consider, in accordance with the terms of those leases and 30 CFR 206.103 (1986), "other relevant matters" in making his value determinations. (Answer at 6). MMS has not shown, however, what "other relevant matters" exist in this case which would support the action taken. In fact, examination of the particular circumstances of this case indicate that Wexpro followed Departmental regulations in 30 CFR and Departmental practice thereunder, in valuing its gas at the tailgate for the period December 1975 through May 31, 1977.

11/ Appellant argues that its lease terms control valuation and that the Btu method of valuation cannot be imposed on its leases, as that method is contrary to the regulations in 30 CFR Part 221 (30 CFR Part 206 (1986)), which are incorporated by reference as part of the leases. However, Congress in the NTL-5 Act specifically found that NTL-5 and its 1986 modification were duly promulgated regulations of the Department. Thus, they must be considered applicable to appellant's leases.

In the preamble to those regulations, MMS set forth what its policy was on dual accounting prior to the regulatory revision. It stated: "The MMS current policy is to require dual accounting for all offshore gas processed by the lessee, including affiliates, and for onshore gas processed by the lessee in a lessee-owned plant or onshore gas sold to an affiliate of the lessee and that affiliate processes the gas." 53 FR at 1257 (emphasis added). Neither circumstance obtains in this case. The Director should take that fact into consideration when reconsidering the valuation in this case.

Therefore, for the above-stated reasons we conclude that the Director erred in his assessment of additional royalty in this case for the period December 1975 through May 31, 1977. In accordance with the applicable Departmental regulations and longstanding Departmental practice, during that period the wet gas, which was not sold at the wellhead, but was processed by an independent third party pursuant to an arm's-length contract, was properly valued for royalty purposes on the value of the dry gas at the tailgate of the processing plant and the lessee's share of the extracted liquids. The Director's decision as it relates to valuation for the remainder of the time period in question must be set aside for the above-stated reasons and remanded to him for reconsideration of the proper valuation. His decision, as it regards late payment charges, is also set aside as indicated above. Should the Director again issue a decision in this case, he should set forth with specificity the exact method of valuation used, as well as the legal basis for applying that valuation.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is reversed in part and set aside in part and the case is remanded to MMS for further action consistent herewith.

Bruce R. Harris
Administrative Judge

I concur:

John H. Kelly
Administrative Judge

